

# CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

## BILL ANALYSIS

---

### **Senate Bill 1527**

**Senator Burton (As amended 4/16/02)**

### **Position:**

**Support (Staff recommendation)**

### **Proponents:**

**Consumers Union, Consumer Attorneys of CA, Consumer Federation of CA**

### **Opponents:**

**Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP, CA Society of Certified Public Accountants, CA Manufacturers and Technology Association**

## **SUMMARY**

Senate Bill 1527 requires an accounting partnership or accountancy corporation to certify that it will not provide non-audit services to an audit client that is a publicly traded corporation. In addition, it would make an accountancy partnership or corporation that violates these requirements subject to discipline for unprofessional conduct.

## **HISTORY**

AB 1995 (Correa, 2000) limits the services a California accountant or accounting firm that certifies corporate financial statements can perform for their audit client to tax preparation services and the review of Securities and Exchange Commission (SEC) filings.

H.R. 3763 (Oxley) prohibits independent auditing firms from providing internal auditing and financial computer system consulting, but permits tax consulting. Permits the SEC to determine additional prohibited services.

S. 2004 (Dodd—Corzine) prohibits accounting firms from providing external auditing and non-auditing services to a client, but allows the provision of tax consulting services if approved in advance by the auditing committee of a client company's board of directors.

S. 2460 (Levin) prohibits an accounting firm from auditing its own work and from providing non-auditing services to a company during the course of its audit contract and for two years afterward.

## **BACKGROUND**

As a major investor in domestic equity and fixed-income markets, the California State Teachers' Retirement System (CalSTRS) and its investment managers rely, among other things, on corporate financial statements and independent audits performed by outside accountants in order

to make informed investment decisions. Accurate financial statements and reliable independent audits are also vital tools in assessing the true value of CalSTRS' investments. The failure of Enron and the role their independent auditor, Arthur Andersen LLP, played in it, exposed the inadequacy of safeguards to protect investors from questionable accounting practices and major conflicts of interest between auditors and their audit clients.

While approximately half the income Andersen generated from its business relationship with Enron was attributed to its role as independent auditor, the other half was generated from the consulting services it provided to the company, such as the development of an automated internal accounting system. Many have expressed concerns that Andersen's duty to accurately reflect Enron's condition in the financial statements it certified was compromised by its effort to improve Andersen's finances by also serving as an accounting consultant to Enron. This practice of providing consulting services to audit clients has become an increasingly common occurrence within the accounting industry and calls into question the independence and objectivity of all independent auditors. From 1993 to 1999, the average annual growth rate for revenues from non-audit services has been 26 percent, while comparable growth rates for audit and tax services have been, 9 percent and 13 percent, respectively over the same period.

Responsibility for the oversight and setting of standards for auditors and the accounting industry is spread among numerous state and federal government agencies and professional organizations. The SEC sets disclosure requirements for securities that are bought and sold in U.S. markets and requires an independent accounting firm audit corporate financial reports annually. The SEC can fine and/or bar accountants from auditing publicly traded companies if they have violated SEC disclosure rules.

The SEC also has the statutory authority to set accounting rules. It has, however, delegated this task to the non-profit Financial Accounting Foundation (FAF). The FAF is run by 16 trustees, the majority of whom are accounting industry representatives. The FAF oversees, funds, and selects the members of the Financial Accounting Standards Board, a 7-member body that sets the rules for how public companies keep their financial records. The American Institute of Certified Public Accountants (AICPA), a professional society, also performs a peer-review function through its ethics division and various oversight committees. However, the most severe disciplinary action imposed by the AICPA is to expel a member from the organization for unprofessional conduct.

Besides regulating most forms of corporate conduct, individual states license accountants and set practice standards. Through statute and regulations, the California Board of Accountancy determines what services an accountant, accounting partnership or accountancy corporation working in the state may provide to a client, specifies what constitutes a conflict of interest, and establishes disclosure requirements and other rules of professional conduct. It also has the authority to strip an accountant of his or her license for violating these laws, regulations, and other professional standards, including generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS).

Existing law requires accounting partnerships and corporations that provide auditing services to undergo a structured peer review of their work before they may renew their license or registration. Board of Accountancy regulations also requires accountants that perform auditing services for government and the private sector to take continuing education classes in the subject. Recently, the Board of Accountancy has made matters related to the audit of public companies a priority because members of the Board believe abuses in this area represent the greatest danger to the consumer.

In April 2002, the Board of Accountancy released its Report and Recommendations on Audit Standards and Practices, which addressed four key areas: 1) record retention and working paper documentation; 2) the influence of non-audit services on auditor independence and objectivity; 3) auditors becoming employees of their clients; and 4) auditor's responsibility to detect and report errors and irregularities. The report included proposed legislation that specifically defines what constitutes audit services and also prohibits auditors of public companies from providing specified non-audit services to their audit clients. According to the report, their list of prohibited services would be consistent with SEC rules, adding two non-audit services to the list of prohibited services (information technology systems design and internal audit outsourcing).

Proposals dealing with issues of investor protection, accounting oversight and corporate governance continue to circulate in Congress, state legislatures, the SEC, and self-regulating industry groups. According to CalSTRS' Washington counsel, a consensus on the proper elements of a new regulatory framework has not formed, and the prospects for passage of reform legislation at the federal level remain unclear.

## **DISCUSSION**

Specifically, Senate Bill 1527:

- Requires an accounting partnership or corporation that applies for a license from the Board of Accountancy to include a certification that it will not provide non-audit services to an audit client.
- Prohibits external auditors from knowingly having a direct financial interest in non-audit services that are provided to a client.
- Defines an audit as any service that results in, or relates to, the delivery of a corporate financial statement according to specified professional standards used to conduct external audits of publicly traded corporations.
- Specifies prohibited non-audit services.
- Provides several non-audit services that can permissibly be offered to audit clients, including tax preparation and services directly related to the delivery of an external audit, including attending meetings or responding to regulatory inquiries.

- Specifies that failure to comply with the certification may result in censure, suspension, revocation, or refusal to renew a license to practice.

According to the author, SB 1527 would address the issue of auditor independence by requiring accounting partnerships and accountancy corporations to certify, in their applications for a license to practice in the state, that they will not provide prohibited non-audit services to their audit clients.

SB 1527 requires only accounting partnerships and accounting corporations to certify that they will not provide non-audit services to outside audit clients that are publicly traded corporations. – individual licensees would not be subject to its provisions. The bill mirrors the recommendations made by the Board of Accountancy by defining what constitutes audit services, non-audit services and authorized non-audit services. All the authorized services relate in some way to the performance of independent audits and preparation of tax returns.

In addition, SB 1527 specifically authorizes the Board of Accountancy to discipline accounting partnerships and accounting corporations working in California that perform unauthorized non-audit services for their outside audit clients. Since any accountant or firm that works in California or serves California clients must obtain a license from the Board of Accountancy, and a licensee working for a California client in another state must continue to follow California law, SB 1527 provides investors a greater degree of confidence in the audited financial statements of California companies. It does not affect, of course, the activities of companies and auditors operating outside of California. As a result, adoption of this proposal at the federal level would be of more widespread effectiveness.

The authorized non-audit services specified in SB 1527 are consistent with those permitted by AB 1995. The provisions of AB 1995, however, apply to all accountants and accounting firms that provide independent auditing services to private and public companies. In addition, AB 1995 specifically permits the Board of Accountancy to expand the list of authorized services under certain conditions, while SB 1527, does not. While the two bills differ in their various provisions (being more restrictive in some areas and less in others) both would improve auditor independence to a similar degree.

With the significant change in the role of external audit firms, and internal audit/financial reporting, the CalSTRS Investment Committee and its Subcommittee on Corporate Governance has approved an extensive plan to promote financial market reforms, including strengthening standards related to corporate audit committee accountability, external auditor independence and disclosure. CalSTRS supports limiting the non-audit services that an external auditor provides a corporation to taxation issues, as well as preventing external auditors from directly investing in audit clients and their affiliates. The Investment Committee has amended the CalSTRS Statement of Investment Responsibility to reflect the change, allowing CalSTRS, as a shareholder, to vote against the selection or retention of an external auditor that violates those policies. The provisions of SB 1527 mirror the recommendations adopted by the CalSTRS Investment Committee regarding external auditor independence and provide another means to

ensure that external auditors and publicly traded companies comply with CalSTRS' corporate governance policies.

### **FISCAL IMPACT**

Benefit Program Costs – None

Administrative Costs – None

### **RECOMMENDATION**

Support. This measure is consistent with the CalSTRS policy that a corporation should limit the non-audit services it receives as an audit client to taxation issues, as well as the System's implementation plan regarding financial market reform. It would, within California, prevent a clear conflict of interest between an independent auditor's duty to investors that need reliable information on the financial state of a company, and their audit client's desire to portray its financial state in the best possible light. A federal limitation, however, is a preferred approach.